

Decision **DRAFT DECISION OF ALJ WALWYN** (Mailed 10/8/2003)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanism for Generation Procurement and Renewable Resource Development.

Rulemaking 01-10-024
(Filed October 25, 2001)

O P I N I O N

1. Summary

This decision grants, in part, Southern California Edison Company's (SCE) request for interim authority to hedge a confidentially specified portion of its natural gas price risk associated with 2004 Qualifying Facility (QF) contracts. SCE seeks Commission approval in advance of the decision on its 2004 short-term plan in order to lower its customers' potential exposure to natural gas prices and obtain more certainty as to the cost of QF energy.¹ We adopt the Office of Ratepayer Advocates (ORA) recommendation that the reasonableness of the price of SCE's hedges will be determined by using specified New York Mercantile Exchange (NYMEX) data sources. In response to the recommendation of The Utility Reform Network (TURN) that SCE review specific details of its hedging strategy and proposed actions with its Procurement

¹ SCE's 2003 hedging authority is under the terms of its Settlement Agreement with the Commission. (See Decision (D.) 03-02-033.)

Review Group (PRG) at the earliest possible date, we find that we agree with TURN's concern that SCE's request is overbroad but choose a different procedural remedy. Therefore, we direct that before buying a specific hedge, SCE conduct a cost-effectiveness test to ensure that there is value to ratepayers before entering into the transaction; we allow SCE to select which commercially available financial model it will use to meet this cost-effective standard.

2. SCE's Request

On September 10, 2003, SCE filed a motion for interim authority to hedge QF natural gas price risk for 2004 and for expedited consideration. SCE states that it has requested this authority in its 2004 Short Term Procurement Plan; however, it has now determined it needs authority prior to the scheduled December 18, 2003 Commission decision on its plan. In support of its need for immediate authority, SCE cites the natural gas price volatility at the Southern California border and at Malin in northern California over the last two years.

SCE requests the Commission shorten time for responses to its motion to September 17, 2003 and waive the provisions of Rule 77.7 of the Commission's Rules of Practice and Procedure, addressing public review and comment on draft decisions. SCE states that it has discussed the relief it seeks here with members of its PRG and believes the motion will be uncontested, although parties may file limited comments addressing certain details regarding the implementation of SCE's request.

On September 18, 2003, the assigned Administrative Law Judge issued a ruling shortening time for responses to September 23, 2003 and stating that the matter would be handled on an expedited basis with the public review and comment period reduced but not waived.

3. Parties' Response to Motion

On September 17, 2003, ORA and TURN filed responses to SCE's motion. Both parties state that the public interest is best served if SCE is allowed to begin hedging in October 2003 rather than January 2003 provided the Commission adopts specific modifications.

ORA agrees with SCE's proposed level of interim authority, a confidential percentage of its natural gas price risk associated with its 2004 QF contracts. This percentage is less than SCE requests in its 2004 short term plan, and is consistent with ORA's recommended percentage limit in the hearing record.

ORA states that SCE's motion seeks permission to hedge using NYMEX futures and options, over-the-counter options, broker basis swaps and bilateral basis swaps. ORA recommends the Commission rule that the reasonableness of SCE's hedges will be determined by comparing SCE's hedge transactions to similar transactions in the NYMEX market, using the following NYMEX data sources:

Table 1: ORA Recommended Data Sources

Contract	Market Benchmark
Futures	NYMEX Natural Gas Futures
Options	NYMEX Natural Gas Options
Malin Basis Swaps	NYMEX Clearpoint Malin Basis Swap (NOI)
SoCal Basis Swaps	NYMEX Clearpoint SoCal Basis Swap (NGI)

TURN states it shares SCE's concerns regarding the ratepayer risks associated with potentially volatile natural gas prices in 2004 and supports the motion subject to a process limitation that would prevent SCE executing hedges without prior consultation with its PRG. TURN states this condition is necessary because SCE has presented the PRG with a wide range of hedging options that

do not adequately demonstrate the particular criteria that will be used in deciding the types and quantities of products to be utilized. Therefore, according to TURN, SCE should be required to share relevant details (actual market data, any internal analyses, and proposed actions) along with an explanation of its underlying hedging “philosophy” with the PRG at the earliest possible date.

On September 25, 2003, SCE filed its reply to the responses of ORA and TURN. SCE objects to the modifications requested by each party that they would limit SCE’s flexibility to exercise judgment within the established boundaries on a real-time basis. SCE urges the Commission to reject the modifications proposed by ORA and TURN and grant, as expeditiously as possible, SCE interim authority to hedge a portion of its QF natural gas price risk for 2004.

4. Discussion

Both ORA and TURN agree that SCE should be allowed to hedge some portion of its natural gas price risk associated with 2004 QF contracts but that additional mechanisms need to be in place to ensure value to ratepayers. SCE proposes a specific methodology for setting maximum volume limits on trading, as set forth in Appendix A to its motion, but does not specify the criteria it will use to determine the value of a hedge or the price to pay for a hedge. ORA's proposed modification is designed to ensure that SCE buys reasonably priced hedges at the time of purchase. TURN, while supportive of ORA's concerns, is more interested in SCE's hedging “philosophy.”

We see TURN's concern going to the issue of whether there is a value to ratepayers in each hedging transaction. TURN addresses its concern by requesting more detailed PRG consultation, a proposal that SCE rejects. We find that a better remedy here is to adopt quantifiable, up-front standards.

The value to ratepayers of whether to engage in specific hedging transactions should be measured by a cost-effectiveness test, as was required for interim procurement contracts already approved by this Commission.

Accordingly, the value of a hedge should at least be commensurate with (and would preferably exceed) its price at the time of purchase. It should be noted that risk reductions beyond certain points can become *de minimis* but at significant cost. Consequently, ratepayers should not be asked to fund utility risk reductions that are not cost-effective. ORA's proposal, that the price of a hedge transaction at the time of purchase must meet a market benchmark, will contribute toward the cost-effectiveness of a hedge. However, the cost-effectiveness of a transaction also depends upon the value of the hedge at the time of purchase. Thus, assurances on price without a determination of value would not sufficiently protect ratepayers.

A cost-effectiveness test allows the Commission to ensure that SCE does not choose to enter hedges at too high a price or for too little value. We faced a similar issue in addressing SCE's November 5, 2002 request in Advice Letter 1660-E for approval of proposed energy and capacity procurement contracts. On December 5, 2002, in Resolution E-3802, we modified SCE's proposed selection criteria to address our finding that SCE's proposed threshold for contract approval was too low, and further refined this process by specifying a specific model and threshold to be used. (See Energy Division's confidential letter of December 6, 2002 regarding Resolution E-3802.) We direct SCE to use this model for a hedge transaction performed under this interim authority or to nominate an alternative, commercially available model that it now uses, to perform the cost-effective test.

With regard to an appropriate threshold, we absolutely insist that the value of a hedge at least be commensurate with the price of the hedge at the time it is purchased. This upfront standard and criteria is clearly in-line with Public Utilities Code Section 454.5, especially Section 454.5(b)(7) which states that "the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the electrical corporation prior to execution of the transaction."

We expect SCE and California's other investor-owned electric utilities to have extensive knowledge of natural gas markets and more expertise about hedging in those markets than we do in the regulatory sphere. The utilities have the responsibility of providing reliable service to their customers at just and reasonable rates; the Commission has the responsibility of adopting a regulatory framework that best ensures customers receive this service. Given the constraints upon the Commission with regard to ex-post review of SCE's actions, it is necessary for us to place some restrictions on the utility's actions beforehand. The Commission must be able to be satisfied that the ratepayers' interests are being served through the methods chosen by SCE to hedge, or not hedge, its gas price risk exposure. By acting according to rules set in place in advance, SCE can make a positive showing of expected benefits, and the Commission can affirmatively conclude that the company has acted reasonably.

We act knowing that denying SCE more complete freedom may be costly to ratepayers in a few cases where standard modeling procedures do not show a benefit, but SCE traders nonetheless claim to see benefits. However, it is our belief that those cases will be few, and the benefits to the ratepayers from relying on standard rules will be many. Moreover, there will be times when markets turn, and previously contracted for hedges will be found, in retrospect, to have

been overly expensive or even useless. Far better for SCE and for the Commission to be able to demonstrate that objective and clear standards were used in selecting the hedges at the time of transaction, and that those hedges were judged at the time, through standardized procedures, to be proper and reasonable.

We find that with the addition of the two upfront standards discussed above, SCE should have interim authority to hedge the natural gas prices risks for its 2004 QF contracts. Therefore, we should grant SCE's request with this modification.

We are concerned that SCE requested expedited consideration rather than submitting its formal request earlier. Informal discussion with the PRG group is to augment, not substitute for, formal Commission review and a full public review and comment period. SCE could, and should, have filed in sufficient time to provide for a normal review period.

5. Comments on Draft Decision

In its September 9, 2003 motion, SCE stated that it had discussed the relief sought in its motion with the members of its PRG and believed that the motion will be uncontested. Therefore, it requested the Commission waive the public review and comment period on the draft decision under the provisions of Rule 77.7(f)(2) of the Commission's Rules of Practice and Procedure (Rule 77.7(f)(2)). However, based on SCE's September 25, 2003 reply, this is a contested matter and we cannot waive public review under this provision.²

² In its September 9, 2003 motion, SCE also requests we waive public review and comment under Rule 77.7(g). SCE purports to define other parties' consent under this

Footnote continued on next page

Under Rule 77.7(f)(9), the Commission may reduce or waive the period for public review and comment if required by public necessity. We find that the public need to quickly grant SCE interim authority to hedge its natural gas price risk associated with 2004 QF contracts clearly outweighs the public interest in having the full 30-day period for review and comment. Therefore, under the authority of Rule 77.7(f)(9), the period for public review and comment is reduced. The draft decision was served on parties on October 8, 2003, with comments due by October 10, 2003. No reply comments will be accepted.

6. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Christine M. Walwyn is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. SCE's request for interim authorization to begin hedging a portion of its natural gas price risk for 2004 QF contracts is generally reasonable.
2. ORA's recommendation that the reasonableness of the price of SCE's hedges should be determined by comparing the hedge transactions to similar transactions in the NYMEX market, as specified in Table 1 of its response, is reasonable.
3. SCE's proposed methodology for setting the maximum volume limits on trading is reasonable for this requested interim authority.

rule. We do not agree with SCE's interpretation, but do not find it necessary to further address the issue here.

4. The value to ratepayers of whether to engage in specific hedging transactions should be measured by a cost-effectiveness test using a commercially available financial model.

5. SCE should use the model identified in the Energy Division's confidential letter of December 6, 2002 regarding Resolution E-3802 or nominate an alternative, commercially available financial model within 5 days of this decision.

6. The value of a hedge should at least be commensurate with (and would preferably exceed) its price at the time of purchase.

Conclusions of Law

1. SCE should be granted its requested interim authorization to hedge natural gas price risks for its 2004 QF contracts subject to the following conditions:

- (a) The value to ratepayers of whether to engage in specific hedging transactions should be measured by a cost-effectiveness test using a commercially available financial model;
- (b) The value of a hedge should at least be commensurate (and would preferably exceed) its price at the time of purchase; and
- (c) The reasonableness of the price of SCE's hedges should be determined by comparing the hedge transactions to similar transactions in the NYMEX market, as specified by ORA in Table 1.

2. This interim authority should expire once the Commission issues a decision on SCE's 2004 Short Term Procurement Plan.

3. SCE should provide the Commission and all interested parties adequate time and opportunity to review formal procurement requests.

4. The time for public review and comment on the draft decision should be reduced because the public need to quickly grant SCE interim authority to hedge

its natural gas price risk associated with 2004 QF contracts clearly outweighs the public interest in having the full 30-day period for review and comment

5. This decision should be effective immediately because SCE needs this interim authority now.

O R D E R

IT IS ORDERED that:

1. The request of Southern California Edison Company (SCE) for interim authorization to hedge a portion of its natural gas price risks for its 2004 Qualifying Facility contracts shall be granted subject to the following conditions:

- (a) The value to ratepayers of whether to engage in specific hedging transactions shall be measured by a cost-effectiveness test using a commercially available financial model;
- (b) The value of a hedge shall at least be commensurate with (and would preferably exceed) its price at the time of purchase; and
- (c) The reasonableness of the price of SCE's hedges shall be determined by comparing the hedge transactions to similar transactions in the New York Mercantile Exchange market, as specified by the Office of Ratepayer Advocates in Table 1.

2. SCE shall use the financial model identified in the Energy Division's confidential letter of December 6, 2002 regarding Resolution E-3802 or nominate an alternative, commercially available financial model within five business days of this decision. If SCE chooses to nominate an alternative model, it shall do so by written notification of the name of the model to the Director of Energy Division, with copies to the service list.

3. This interim authority shall expire once the Commission issues a decision on SCE's 2004 Short Term Procurement Plan

This order is effective today.

Dated _____, at San Francisco, California.